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IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

FIRST APPELLATE DISTRICT

DIVISION TWO

KOOROSH KAMKARI, Plaintiff and Appellant, v. SONIC SOLUTIONS et al., Defendants and Respondents.	A123028 (Marin County Super. Ct. No. CV075442

Koorosh Kamkari appeals from an order sustaining respondents' demurrer to his complaint for breach of fiduciary duty and violations of the California Corporations Code and dismissing his complaint. His claims against Sonic Solutions and a number of its officers and directors are based on allegations that the defendants made misrepresentations and failed to disclose material facts regarding improper backdating of stock options; that the backdating practices resulted in overstatement of the company's value; and that, as a result, appellant and class members paid artificially inflated prices for their shares of Sonic stock. Appellant argues the trial court erred in concluding that certain of his claims were preempted under federal law and others were derivative. We affirm.

STATEMENT OF THE CASE AND FACTS

According to the allegations of the amended complaint, Sonic Solutions (Sonic) is a California corporation, based in Novato, that develops and markets computer software related to digital media. Appellant is a current Sonic shareholder.

On February 1, 2007, Sonic announced that it was commencing a voluntary review of its historical and current stock option grant practices and related accounting. The audit committee, comprised of independent directors with assistance from independent legal counsel and outside consultants, subsequently concluded that, for a large portion of the options issued prior to September 23, 2005, "there is little or no contemporaneous grant-specific documentation that satisfies the requirements for 'measurement dates' under [Accounting Principles Board Opinion] No. 25 and that would allow [Sonic] to maintain the original grant date used for accounting purposes . . . ." The audit committee stated that there was no intentional wrongful conduct by Sonic employees, officers or directors, and no evidence they "had any knowledge that their handling of option grants violated stock option accounting rules." On February 26, 2008, Sonic filed its form 10-K with the Securities and Exchange Commission (SEC) for the fiscal year ended March 31, 2007, which restated its prior financial statements to adjust for compensation expenses related to stock option grants.

Meanwhile, as described in the declaration of Sonic's counsel, after Sonic's February 1, 2007 announcement, four substantially similar federal derivative shareholder complaints were filed against the company and individual officers and directors between March and June 2007, alleging various causes of action relating to the historical and current dating and pricing of Sonic's stock options. These actions were consolidated as *Wilder v. Doris, et al.* (U.S. Dist. Ct., N.D.Cal, No. C 07-1500 CW). In June 2007, a state shareholder derivative action was filed against Sonic and individual defendants in Marin County Superior Court, *McCay v. Doris et al.* (No. CV 07-3038), alleging causes of action for unjust enrichment, breach of fiduciary duty, violation of California Corporations Code sections 25402 and 25403,[1] abuse of control, gross mismanagement, waste of corporate assets, accounting, rescission and constructive trust. In October 2007,

[1] All further statutory references are to the Corporations Code unless otherwise indicated.

a federal class action was filed, *City of Westland Police and Fire Retirement System v. Sonic Solutions et al.* (U.S. Dist. Ct., N.D. Cal., No. CO7-5111 JSW), asserting federal securities law claims against Sonic and individual defendants.

On November 16, 2007, appellant filed the present class action complaint for breach of fiduciary duty against Sonic and five individual defendants, all Sonic directors and/or officers. The complaint alleged, on behalf of individuals who owned common stock of Sonic between July 12, 2001 and May 17, 2007 (the "class period"), that certain current and former officers and members of the Board of Directors breached their fiduciary duties by failing to inform shareholders that they had issued backdated stock options to Sonic's directors and top executive officers.

According to the allegations of the complaint, prior to the class period, Sonic manipulated its stock option accounting, causing its filings with the SEC during the class period to be false. Sonic's public disclosures were alleged to have falsely represented that the exercise price of its stock options would be not less than the fair market value of its common stock, measured by the publicly-traded closing price on the date of the grant of the options, whereas in fact the options were backdated, in many instances dated just before a sharp increase in the trading price or at the bottom of a steep drop in the stock's price. The complaint alleged that the backdating "line[d] the pockets of Sonic's directors and executives at the direct expense of the Company," which received less money upon exercise of the options, and "resulted in the overstatement of the company's publicly reported financial results since at least 2001." Appellant alleged that the defendants' conduct unjustly enriched Sonic's top executives, misled its public shareholders, and exposed Sonic to a costly investigation by the SEC and costly internal investigations into the company's compliance with federal securities law and accounting rules, and that the class was harmed as a result of the dilution of its voting power and proportionate share of the company.

Respondents demurred on several grounds, including that the cause of action could not be asserted directly on behalf of shareholders but only derivatively on behalf of the corporation because, to the extent the defendants breached their fiduciary duties, the alleged harm to shareholders was only incidental to harm to the company. The trial court agreed, holding that appellant's claims were "derivative rather than direct" in that appellant alleged that the backdating of options reduced the value of the entire corporate entity and "the injury claimed by plaintiff (shareholders not having true facts when they voted on the option plans) is not '*independent of any alleged injury to the corporation*' " as required by caselaw. Expressing doubt that appellant could amend to state a direct claim, the trial court sustained the demurrer with leave to amend.

Appellant's amended complaint was filed on April 22, 2008. Count I of the complaint again alleged breach of fiduciary duty regarding the backdating of stock options, resulting in material overstatement of the company's net income and retained earnings in proxy statements and reports filed with the SEC. Count II alleged violation of section 1507, in that as a result of the backdating scheme, enumerated proxies and SEC filings materially overstated the company's net income and retained earnings and the class relied upon the materially false statements and was damaged thereby. Count III alleged violation of sections 25400 and 25500 in that the defendants made false and misleading statements to induce purchase of Sonic stock by appellant and the class, as a result of which appellant and class members paid artificially inflated prices for their Sonic stock.

Respondents demurred to the breach of fiduciary duty claim, again on the basis that it was derivative rather than direct. Respondents demurred to the Corporations Code claims on the grounds that they were preempted by the Securities Litigation Uniform Standards Act (SLUSA) and that the complaint failed to state a cause of action under the statutes. The trial court sustained the demurrer to the first cause of action without leave to amend, finding that appellant had not amended the complaint to show any injury to the

shareholders independent of that to the corporation. The court sustained the demurrers to the other causes of action with leave to amend. The court found the section 1507 cause of action, which it viewed as based upon shareholders' voting to approve the stock option plans without knowledge of the backdating, was derivative. It found the section 25400 and 25500 claims, based upon purchase of shares at inflated prices, preempted by SLUSA. The order sustaining the demurrers was filed on July 14, 2008.

On July 30, 2008, respondents filed an ex parte application for dismissal of the amended complaint with prejudice and entry of final judgment. The same day, the court filed its order dismissing the complaint with prejudice and entering final judgment.

Appellant filed a timely notice of appeal on September 26, 2008.

DISCUSSION

Appellant argues that the court erred in finding his claims under sections 25400 and 25500 preempted by SLUSA, and in dismissing his section 1507 claim as derivative. He concedes that, if we find the cause of action under sections 25400 and 25500 preempted, his cause of action under section 1507 would be preempted as well. He does not challenge the trial court's dismissal with respect to his fiduciary duty claim.

We review a trial court's ruling on a demurrer independently. (*Tarkington v. California Unemployment Ins. Appeals Bd*. (2009) 172 Cal.App.4th 1494, 1502.) " 'It is the rule that when a plaintiff is given the opportunity to amend his complaint and elects not to do so, strict construction of the complaint is required and it must be presumed that the plaintiff has stated as strong a case as he can.' (*Gonzales v. State of California* (1977) 68 Cal.App.3d 621, 635; see also *Chicago Title Ins. Co. v. Great Western Financial Corp*. (1968) 69 Cal.2d 305, 312 [the plaintiff's failure to amend 'constrained [us] to determine only whether appellants state a cause of action, not whether they might have been able to do so'].)" (*Reynolds v. Bement* (2005) 36 Cal.4th 1075, 1091.) In these circumstances, "we will affirm the judgment if the unamended complaint is objectionable

on any ground raised by the demurrer. (*Soliz v. Williams* (1999) 74 Cal.App.4th 577, 585.)" (*Gutkin v. University of Southern California* (2002) 101 Cal.App.4th 967, 981.)

"SLUSA has been described as 'the most recent in a line of federal securities statutes originating with Congress' passage of the Securities Act of 1933 [(1933 Act)], 48 Stat. 74 (1933) (codified as amended at 15 U.S.C. § 77a et seq.), and the Securities Exchange Act of 1934 [(1934 Act)], 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. § 78a et seq.), and continuing through Congress' 1995 passage of the Private Securities Litigation Reform Act of 1995 [(PSLRA)], Pub.L. 104-67, 109 Stat. 737 (1995) (codified in part at 15 U.S.C. §§ 77z-1, 78u).' (*Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* [(11th Cir. 2002)] 292 F.3d 1334, 1340 . . . .) Under SLUSA, federal court is the exclusive venue for fraud claims 'in connection with the purchase or sale of a covered security' and the statute itself specifically provides for removal of such claims to federal court. The statute was originally enacted in 1998 because heightened pleading requirements in federal securities cases caused a pilgrimage of securities claims to state courts, thus circumventing congressional reforms designed to restrict federal securities claims. (*Id*. at [p.] 1341; *Dudek v. Prudential Sec., Inc*. [(8th Cir. 2002)] 295 F.3d 875, 877 . . . .)" (*Falkowski v. Imation Corp*. (9th Cir. 2002) 309 F.3d 1123, 1128 (*Falkowski*); *Kenneth Rothschild Trust v. Morgan Stanley Dean Witter* (C.D. Cal. 2002) 199 F.Supp.2d 993, 997 [Congress enacted SLUSA "to ensure that litigants do not circumvent the limitations of the [PSLRA] by filing their securities actions in state court"].)

SLUSA provides that "[n]o covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging—[¶] (1) an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security; or [¶] (2) that the defendant used or employed any manipulative or deceptive device or contrivance in

connection with the purchase or sale of a covered security." (15 U.S.C. §§ 77p(b); 78bb(f)(1).)

Section 25400 prohibits the use of false or misleading statements to induce purchase or sale of securities.[2] Section 25500 makes any person who engages in a

[2] Section 25400 provides: "It is unlawful for any person, directly or indirectly, in this state:

"(a) For the purpose of creating a false or misleading appearance of active trading in any security or a false or misleading appearance with respect to the market for any security, (1) to effect any transaction in a security which involves no change in the beneficial ownership thereof, or (2) to enter an order or orders for the purchase of any security with the knowledge that an order or orders of substantially the same size, at substantially the same time and at substantially the same price, for the sale of any such security, has been or will be entered by or for the same or different parties, or (3) to enter an order or orders for the sale of any security with the knowledge that an order or orders of substantially the same size, at substantially the same time and at substantially the same price, for the purchase of any such security, has been or will be entered by or for the same or different parties.

"(b) To effect, alone or with one or more other persons, a series of transactions in any security creating actual or apparent active trading in such security or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others.

"(c) If such person is a broker-dealer or other person selling or offering for sale or purchasing or offering to purchase the security, to induce the purchase or sale of any security by the circulation or dissemination of information to the effect that the price of any such security will or is likely to rise or fall because of market operations of any one or more persons conducted for the purpose of raising or depressing the price of such security.

"(d) If such person is a broker-dealer or other person selling or offering for sale or purchasing or offering to purchase the security, to make, for the purpose of inducing the purchase or sale of such security by others, any statement which was, at the time and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, or which omitted to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, and which he knew or had reasonable ground to believe was so false or misleading.

"(e) For a consideration, received directly or indirectly from a broker-dealer or other person selling or offering for sale or purchasing or offering to purchase the security, to induce the purchase or sale of any security by the circulation or dissemination of information to the effect that the price of such security will or is likely to rise or fall

willful violation of section 25400 liable in damages to a person who purchases or sells a security at a price that was affected by the proscribed conduct.[3] Appellant does not suggest his class action claims under these statutes do not come within the purview of SLUSA, but argues that they are not preempted because of an exception known as the "Delaware carve-out." (See *Sofonia v. Principal Life Ins. Co.* (S.D. Iowa 2005) 378 F.Supp.2d 1124, 1133 (*Sofonia*).)

Under this exception, a covered class action may be maintained in state or federal court if it "involves":

"(I) the purchase or sale of securities by the issuer or an affiliate of the issuer exclusively from or to holders of equity securities of the issuer; or

"(II) any recommendation, position, or other communication with respect to the sale of securities of an issuer that—

"(aa) is made by or on behalf of the issuer or an affiliate of the issuer to holders of equity securities of the issuer; and

"(bb) concerns decisions of such equity holders with respect to voting their securities, acting in response to a tender or exchange offer, or exercising dissenters' or appraisal rights." (15 U.S.C. §§ 78bb(f)(3)(A)(ii), 77p(d)(1)(B).)

The plaintiff bears the burden of showing that the carve-out applies. (*Sofonia, supra,* 378 F.Supp.2d at p. 1134.)

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because of the market operations of any one or more persons conducted for the purpose of raising or depressing the price of such security."

[3] Section 25500 provides: "Any person who willfully participates in any act or transaction in violation of Section 25400 shall be liable to any other person who purchases or sells any security at a price which was affected by such act or transaction for the damages sustained by the latter as a result of such act or transaction. Such damages shall be the difference between the price at which such other person purchased or sold securities and the market value which such securities would have had at the time of his purchase or sale in the absence of such act or transaction, plus interest at the legal rate."

"The testimony before Congress when it inserted the Delaware carve-out into SLUSA suggests that the purpose of [15 U.S.C.] § 77p(d) was to preserve state-law actions brought by shareholders against their own corporations in connection with extraordinary corporate transactions requiring shareholder approval, such as mergers and tender offers, regardless whether the corporations issued nationally traded securities." (*Madden v. Cowen & Co*. (9th Cir., Aug. 7, 2009, No. 07-15900) 2009 U.S. App. LEXIS 17657, *31.)[4]

The trial court found that appellant's statutory claims did not come within the first prong of the Delaware carve-out because it could not be determined from the face of the complaint that all the class members already owned shares at the time they purchased the shares at inflated prices. As stated above, this exception applies to cases that "involve" a purchase or sale of securities "exclusively from or to holders of equity securities of the issuer" (15 U.S.C. § 78bb(f)(3)(A)(ii)(I)), that is, "claims arising from an offering of a company's securities to its *existing equity security holders*." (*Sofonia, supra*, 378 F.Supp.2d at p. 1133.) The exception does not apply where the stock is sold in the

[4] The footnote *Madden* appended to this statement provides: "*See, e.g., Securities Litigation Uniform Standards Act of 1997: Hearing on S. 1260 Before the S. Comm. on Banking, Housing, and Urban Affairs, Subcomm. on Securities*, 105th Cong. 48 (Oct. 29, 1997) (statement of SEC Chairman Arthur Levitt and Commissioner Isaac Hunt, Securities and Exchange Commission) (expressing concern that the version of SLUSA originally introduced in the Senate 'could preempt state class actions for damages based on material misstatements or omissions in proxy and tender offer materials in connection with an extraordinary corporate transaction'); *Securities Litigation Uniform Standards Act of 1997: Hearing on H.R. 1689 Before the H. Comm. on Commerce, Subcomm. on Finance and Hazardous Materials*, 105th Cong. 64 (May 19, 1998) (testimony of Jack Coffee) (noting the important role of state class actions in the area of mergers and corporate reorganization and approving of the Senate's addition of the Delaware carve-out as an 'attempt[]' to 'carve back into the statute a role for the Delaware courts, and the courts of other States, to deal with fundamental questions of corporate governance')." (*Madden v. Cowen & Co., supra,* 2009 U.S. App. LEXIS 17657, *31, fn. 7.)

open market. (*G.F. Thomas Investments, L.P. v. Cleco Corp.* (W.D.La. 2004) 317 F.Supp.2d 673, 681-685 (*Cleco*).)

The court found the statutory cause of action did not come within the second prong of the Delaware carve-out because it did "not involve voting, acting in response to a tender or exchange offer, or exercising dissenters' or appraisal rights."

Appellant's claim under sections 25400 and 25500, as we have said, is that the price he paid for his Sonic stock was artificially inflated because of the company's backdating of stock options. An employee stock option "is a contractual duty to sell a security at a later date for a sum of money, should the employee choose to buy it." (*Falkowski, supra,* 309 F.3d 1123, 1130.) An option grant "is a sale under the securities laws because it is a contract to sell a security when the option is exercised." (*Ibid.*) According to appellant, since Sonic's grant of stock options to its directors, officers and employees was a "sale" of the underlying securities, when the options were later exercised and exchanged for stock, the latter transaction was a sale of securities exclusively to holders of Sonic's equity securities and therefore within the first prong of the Delaware carve-out. The case comes within the second prong of the carve-out, according to appellant, because the allegedly false and misleading statements were made in proxy statements by which Sonic made recommendations to its shareholders about how to vote on the granting of options.

Appellant maintains that federal district courts have consistently ruled that causes of action related to options backdating are not subject to SLUSA because they come within the Delaware carve-out exception. The cases he cites in this regard, however, involve claims by existing shareholders that misrepresentations and omissions relating to backdating of stock options affected their votes on company stock option plans. *Pace v. Bidzos* (N.D. Cal., Oct. 3, 2007, No. C 07-3742) 2007 U.S. Dist. LEXIS 76909, at pages *2, *5, involved claims of breach of the duty of disclosure in connection with alleged backdating of stock options, based on proxy statements urging shareholders to vote on an

increase in the number of shares available for option grants, and sought rescission of amendments to the option plans. The complaint in *City of Ann Arbor Employees' Retirement System v. Gecht* (N.D.Cal., March 9, 2007, No. C 06-7453) 2007 U.S. Dist. LEXIS 21928, alleged that various officers and directors breached their fiduciary duty by failing to disclose their practice of backdating stock options in a proxy statement seeking shareholder approval of amendments to the company's stock option plans that increased the number of shares authorized for issuance. *Gecht* described the gist of the complaint as alleging "that '[a] shareholder who knew that Company executives backdated options granted under prior plans (thereby providing not only improper compensation to [company] directors and employees but also artificially inflating net income and rendering certain tax deductions unavailable) would not have voted in favor of [the amendments].' " (*Id.* at pp. *2-*3.) The claim in *Indiana Electrical Workers Pension Trust Fund, IBEW v. Millard* (S.D.N.Y., July 26, 2007, No. 07 Civ. 172) 2007 U.S. Dist. LEXIS 54203, at page *2 (*Millard*), was that the defendants breached their fiduciary duty of disclosure "by making misrepresentations and failing to disclose material facts about a scheme of improperly backdating stock options and thereby persuading shareholders to vote to authorize an increase in the number of shares available" under a stock option plan.

Unlike these cases, appellant's section 25400 and 25500 claims do not allege that he was misled in voting to approve the option plans. Rather, appellant's claim is a step removed: He argues that the backdating resulted in the over-valuation of Sonic stock that in turn resulted in his paying an artificially inflated price for the stock on the open market. Appellant views his claims as within the ambit of the Delaware carve-out because the alleged misrepresentations with respect to backdating options were made by the defendants in seeking shareholder approval of the stock option plans and so involved "the purchase or sale of securities by the issuer or an affiliate of the issuer exclusively from or to holders of equity securities of the issuer" and "communication with respect to the sale of securities of an issuer . . . made by or on behalf of the issuer . . . to holders of

equity securities of the issuer," concerning "decisions of such equity holders with respect to voting their securities." (15 U.S.C. §§ 78bb(f)(3)(A)(ii), 77p(d)(1)(B).) But the transaction at issue in appellant's claims under sections 25400 and 25500, concerning the use of false or misleading statements to induce the purchase or sale of securities, was not the adoption of the stock plan or Sonic's employees' exercise of their options; it was appellant's alleged purchase of Sonic stock at a price that was artificially inflated because of the backdating of stock options.

As we have said, the Delaware carve-out does not apply to a transaction in which stock is sold on the open market. (*Cleco, supra*, 317 F.Supp.2d at pp. 681-685.) *Cleco* was a class action on behalf of shareholders who, while already Cleco shareholders, purchased additional Cleco securities. (*Id.* at p. 676.) Alleging that the company issued false and misleading statements regarding its financial condition, the plaintiffs argued that the case came within the first prong of the Delaware carve-out—a case that "involves . . . the purchase or sale of securities by the issuer or an affiliate of the issuer *exclusively from or to holders of equity securities of the issuer*"—because all members of the class were already shareholders when they purchased the securities at issue. (*Id.* at pp. 677, 681-682.) The court rejected this argument, holding that "only when shares of stock are purchased or sold to a limited market (that of the corporation's current shareholders) will the Delaware carve-out provision apply. When the stock is offered to the open market, SLUSA governs the prospective class action. (*Id.* at p. 682.) Although only the first prong of the Delaware carve-out was involved in *Cleco*, the court noted that legislative history also limited the second prong "to those situations where there is direct contact with the shareholders." (*Id.* at p. 684.) This observation was based upon the following legislative history from the Senate Banking Committee:

"The SEC, as well as other commentators, also noted the need to exempt from the legislation shareholder-initiated litigation *based on breach of fiduciary duty* of disclosure,

in connection with the certain corporate action, that is found in the law of some states, most notably Delaware.

"The Committee is keenly aware of the importance of state corporate law, specifically those states that have laws that establish a fiduciary duty of disclosure. It is not the intent of the Committee in adopting this legislation to interfere with state law regarding the duties and performance of an issuer's directors or officers in connection with a purchase or sale of securities by the issuer or an affiliate from current shareholders or communicating with existing shareholders with respect to voting their shares, acting in response to a tender or exchange offer, or exercising dissenters' or appraisal rights." (S. Rep. 105-185, at 6 (May 4, 1998)." (*Cleco, supra*, 317 F.Supp.2d at p. 684, quoting *Alessi v. Beracha* (D.Del. 2003) 244 F.Supp.2d 354, 359.)

Teamsters Local 617 Pension and Welfare Funds v. Apollo Group, Inc. (D.Az., March 31, 2009, No. 2:06-CV-2674) 2009 U.S. Dist. LEXIS 31832, at pages *5-*6 (*Apollo*), like the case before us, involved claims that the plaintiff and class members purchased stock at artificially inflated prices due to a backdating scheme. The complaint alleged that the backdating scheme caused the company to issue materially false and misleading financial statements, resulting in an artificial inflation of the company's stock price; that through the backdating scheme the defendants concealed that the company was not recording material compensation expenses and was materially overstating its net income and earnings per share; and that as a result, the plaintiff purchased Apollo stock at artificially inflated prices.

The *Apollo* court found it "readily apparent that plaintiff's state law claims do not meet the criteria of the first prong" of the Delaware carve-out. With respect to the second prong, the court stated: "Apparently plaintiff is attempting to rely upon the second prong because it cites to [*Millard, supra,* 2007 U.S. Dist. LEXIS 54203], where the court did hold that that prong precluded removal. *Millard* is readily distinguishable, though, in that it included allegations 'that the defendants misrepresented the way the strike prices for L-

3's stock options were calculated in proxy statements sent to shareholders . . . and that th[o]se misstatements led the shareholders to authorize the Board to dedicate 6.5 million additional shares to the stock option plan.' [(]2007 U.S. Dist. LEXIS 54203, at p. *4.[)] The *Millard* court found that those allegations 'relate[d] to communications concerning a shareholder vote[,]' thus satisfying the ' "voting their security" element of prong (II).' [(]2007 U.S. Dist. LEXIS 54203, at p. *8.[)] [¶] Here, the [complaint] does not include any such similar allegations pertaining to Apollo's proxy statements." (*Apollo, supra,* 2009 U.S. Dist. LEXIS 54203, at pp. *193-*194.) Accordingly, *Apollo* held the state law claims were not exempt from SLUSA under the Delaware carve-out. (*Id.* at p. *194.)

The amended complaint in the present case does allege that proxies soliciting shareholders' votes on the option plans contained false and misleading information, although the allegations are only that the shareholders were not aware of this when they voted to approve the plans. More importantly, the complaint does not allege that appellant or other class members were misled in voting their shares. As discussed above, appellant's claim under sections 25400 and 25500 is based on his purchase of stock on the open market. The communications to shareholders and their votes on the option plans create the backdrop for appellant's claim that the price he paid was artificially inflated, but the gravamen of his claim is the open market transaction, not the alleged misconduct internal to the corporation.

Appellant argues that there is a sufficient connection between the alleged fraud in obtaining shareholders' approval of the option plans and the inflated stock price about which he complains to find that the former "involves" the latter within the meaning of the carve-out provisions. He points to caselaw viewing the language of the carve-out provision generally, or the term "involve" specifically, as "broad." (*Millard, supra,* 2007 U.S. Dist. LEXIS 54203, *15; *In re MetLife Demutualization Litigation* (E.D.N.Y., Aug. 28, 2006, CV 00-2258) 2006 U.S. Dist. LEXIS 60104, *18 (*MetLife*).)

Millard, construing the phrase " 'with respect to the sale of securities' in prong (II) of the Delaware carve-out," simply noted that cases have called language of the carve-out broad, and rejected the defendants' assertion that the carve-out should be read narrowly. (*Millard, supra,* 2007 U.S. Dist. LEXIS 54203, *14-*15.)

In *Lewis v. Termeer* (S.D.N.Y. 2006) 445 F.Supp.2d 366, one of the cases *Millard* cited, the court interpreted the term "involve" broadly rather than narrowly in the context of rejecting the defendants' argument that the Delaware carve-out did not apply to shareholder claims of fraud in a stock exchange in connection with a merger because some of the shareholders sold their shares on the open market instead of tendering them to the corporation. (*Id.* at pp. 368-373.) The court accepted the plaintiffs' argument that the fraudulent scheme "involved, and centered on, the Exchange transaction which was only between [the corporation] and its shareholders" and "involve[d] communications and recommendations by the issuer concerning matters such as exchange offers, as well as the actual exchange itself." (*Id.* at p. 372.) In essence, the plaintiffs alleged fraud in the exchange by which they, as shareholders of the company, tendered their shares to the company, and the fact that some of the shareholders sold their stock rather than participating in the exchange did not alter the fundamental nature of the challenged transaction.

MetLife, supra, 2006 U.S. Dist. LEXIS 60104, another of the cases *Millard* cited, involved a several-step demutualization process by which MetLife Co. converted from a mutual life insurance company to a stock life insurance company called MetLife, Inc. Plaintiffs, former policy holders who exchanged their policies for stock as part of the demutualization process, alleged that the information booklet in which the directors urged approval of the process contained misrepresentations and material omissions, including that MetLife, Inc. issued an excess supply of shares in an initial public offering, depressing the stock price, as part of an undisclosed share buyback scheme. (*Id.* at pp. *4-*7.) The court referred to the broadness of the term "involve" in holding that

MetLife Co. could be viewed as the "issuer" for purposes of the carve-out even though MetLife, Inc. issued the IPO shares. (*Id.* at pp.*16-*19.) After explaining that the alleged misconduct was attributed to MetLife Co. officers and directors, the court went on to state: "A permissible action is any covered class action which 'involves the purchase or sale of securities by the issuer[.]' [15 U.S.C.] § 78bb(f)(3)(A)(ii). The definition of 'involve' is quite broad, indicating that a number of securities may be purchased or sold. *See* Webster's II New Riverside Dictionary (Rev. Ed. 1996) at [p.] 367 (defining 'involve' as 'to contain as a part.') Thus, the Delaware Carve Out could apply to both MetLife Co. and MetLife, Inc. shares." (*MetLife*, at pp. *18-*19.)

MetLife referred to the "broad" language of the carve-out again in rejecting the argument that the case did not come within its second prong because some of the policyholders, who held only voting rights but not interests in the company's surplus, were not "equity security holders." ([15 U.S.C.] § 788bb(f)(3)(A)(ii)(II).) The court stated, "Again, the broad language of the Section controls. The class action need only 'involve' a recommendation with respect to the sale of securities. The statute does not state, nor even imply, that all class members must be able to act on such recommendation." (*MetLife*, *supra*, 2007 U.S. Dist. LEXIS 54203, at p. *23.)

MetLife's conclusions that the language of the carve-out was broad enough to encompass a case challenging two issuers' shares and recommendations on voting made to nonequity as well as equity shareholders, has little bearing on the very different question presented in the case before us. *MetLife* clearly concerned an internal matter of corporate governance: The challenge was leveled by shareholders who had been induced to take certain action with respect to their shares by the alleged misconduct. In the present case, appellant asks us to interpret the term "involve" in a very different manner, i.e., to permit him to bring a claim based on an open market purchase of securities within the carve-out because the price he paid was allegedly affected by fraud perpetrated against the shareholders who approved the stock option plans. If the carve-out applies to

any case that "involves" the matters of corporate governance it describes, even where the plaintiff is affected by those matters indirectly, on the open market, the potential reach of the exception would be far greater than Congress appears to have intended. Such a broad interpretation of the Delaware carve-out would undermine SLUSA's purpose of limiting most securities class actions to federal court.

Proctor v. Vishay Intertechnology, Inc. (N.D.Cal., Feb. 13, 2007, No. C 06-04134) 2007 U.S. Dist. LEXIS 14547, recognized that the Delaware carve-out requires a degree of connection between the plaintiffs' claim and the conduct defined by the provision. There, minority shareholders alleged that false and misleading statements in financial documents prepared by the company's auditor resulted in the lowered value of shares they were offered during a tender offer. The court held the carve-out did not apply because the alleged communications took place over a period of years and were not made specifically in relation to the tender offer: "[T]he Delaware carve-out relates only to communications that are directly related to the exercise of shareholders' voting rights in the context of tender or exchange offers, or dissenter or appraisal rights. A holding that communications made over an extended period of time and alleged to have some ultimate impact on a shareholder's decision also fall within the exception would render the exception far too broad." (*Id.* at pp. *20-*23.) Here, the alleged misconduct with respect to the company's shareholders was even more attenuated from the transaction appellant alleged to have caused him injury.

The trial court correctly determined that appellants' claims under sections 25400 and 25500 do not fall within the terms of the Delaware carve-out. As appellant concedes that if this is the case, his cause of action under section 1507 is also preempted by SLUSA, we need not address his arguments with respect to the section 1507 claim. The judgment is affirmed.

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Kline, P.J.

We concur:

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Haerle, J.

_____
Richman, J.